Preface to the Second Edition

When the first edition of this text appeared in 2002, the full impact that credit scoring and consumer credit modeling would have on the whole of global finance and global banking regulations in the next decade and a half had not yet been realized.

In banking regulations the development and implementation of the Basel Accords, Basel II and Basel III, concerning capital requirements when dealing with credit and other banking risks, has led to credit scoring, which is the methodology that allows banks to estimate the credit risk in their consumer portfolios. So credit scoring, particularly behavioral scoring, has become an essential tool for running a consumer-relevant bank. Moreover, the objective of a scorecard in the Basel context is to estimate the probability of the borrower defaulting rather than merely ranking the risk of the borrower, which was the objective of the original application scorecards. Thus, there are new ways of measuring how good a scorecard is, as found in Chapter 8. There is also the need for stress testing the models and even introducing new models to estimate Loss Given Default (LGD) and Exposure at Default (EAD). These are found in the new chapter on the Basel Accord (Chapter 11)

On the negative side, the subprime mortgage problems, which began in the U.S. in 2007, triggered the most difficult global financial conditions for many years. Financial institutions, banks, whole economies, and even large countries are still struggling to cope with a decade of poor economic growth and real consumer, company, and country debt problems. Although credit scorecards stood up better in these difficult situations than the models of the default risk of mortgage-backed securities and other products proposed by rating agencies, many problems were identified. Some of these are addressed in Chapter 12. The main problem was that instead of the credit scoring models describing reality, lenders wanted to game the model rather than make sure it described the real situation. Their objective was to optimize the outcome of the model no matter what. This showed the problems of having transparent models which could be gamed and the need to move to credit scoring models which could measure the default risk over any different time periods. Standard scorecards used a traditional horizon of up to two years, and the Basel behavioral scoring models used a one-year time horizon, whereas the default risk the lender was concerned about was of an even shorter duration. It also showed the need to allow dynamics into the credit scoring models so that they could cope with changing economic conditions. Several of these problems, like the need for the scoring system to give results over any time horizon and the ability to include dynamic economic conditions into the scorecard, can be dealt with by using the survival analysis approach to credit scoring. The details of this are found in Chapter 5 of this edition. One trend that was limited by the global financial crisis was the move to variable or risk-based pricing. The privacy of channels like the Internet or telephone banking meant lenders could offer borrowers different interest rates. In fact, the "fire fighting" needed to deal with the fallout from the global financial crisis often stopped such developments. However, as Chapter 13 shows, the profitability modeling based on credit scorecards is well advanced.

Although not represented in this second edition, contemporary consumer credit issues are also emerging. These include peer-to-peer lending and crowd-funding, where several lenders support the same loan. The success of micro-finance projects shows that for some sort of lending, the objective is much more complex than the monetary profit of the loan.

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